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"At any rate, a monetary expansion results in misinvestment of capital and overconsumption. It leaves the nation as a whole poorer, not richer."

Human Action, Ludwig von Mises, p.470
Contemporary Books, Chicago

HIGHLIGHTS

It's now clear — the explosive dollar rally of this year, so convincingly launched by the post-Gulf-War euphoria, was based on nothing more than a wishful pipe dream. It was just a violent counter rally in the context of a long-term bear market.

Furthermore, the early recession countries — United States, Britain, Canada, Australia, and others — are in no position to lead a global upturn. Consumers, corporations, and governments of these countries are unable to finance a traditional recovery.

Economic growth is slowing almost everywhere. It's time to start pondering the probability and implications of a worldwide recession in 1992.

Only a renewed credit boom or an externally-driven export boom can lift the Anglo-Saxon countries out their economic downturns. Neither is likely, especially so now that the rest of the world is slowing.

Economists everywhere — in Washington, on Wall Street, and in Europe — remain relatively upbeat. Why? They are again making the mistake of the late 1920s. They are drawing false comfort from declining inflation and interest rates as reliable precursors of economic growth.

To illustrate, we review the famous inflation argument that took place between Keynes and several other economists in 1928. An incorrect understanding of inflation led to a dangerous complacency. The same dangerous complacency is apparent again today.

Canada is a prime example of the "declining inflation is good" view. As a result, foreign indebtedness is the only thing that's booming. An examination of Canada's financial and economic underpinnings reveals an enormous speculative bubble.

The major casualty of declining inflation in all the Anglo-Saxon countries is corporate profits. They have virtually imploded and, in some cases, have fallen to the lowest levels since the 1930s.

Recessions, though painful, act to rebuild liquidity and savings levels, thus recharging the batteries for future growth. So far, excepting rising savings rates in Britain, none of these curative effects have been evident. To the contrary, budget deficits are increasing while savings stagnate.

Stock markets and the U.S. dollar are vulnerable and remain sharply out of kilter with reality.

FRAYING CONFIDENCE

If any question remained, it's now clearly evident that this year's upside stampede of the dollar was just a phoney, albeit huge, speculative bubble. It was a remarkable masquerade — extraordinarily steep and brief — convincing, and perhaps even scaring, the vast majority into an enduring "bull run" in the dollar. In only four months, the dollar gained a stupefying 28% against the D-mark.

The U.S. currency blasted off on a wave of post-Gulf-War euphoria further propelled by the consensus conviction of an imminent U.S. economic recovery and the prospect of a faltering European economy. The popular reasoning was that sharply narrowing differentials in real GNP growth and interest rates between the two economies would push up the dollar toward DM 2.00 by year-end. The markets believed and promptly obliged.

As it turned out, the underpinning for the dollar spurt was nothing more than rampant fantasy. Now, the dollar is being driven down on the growing recognition that the widely predicted U.S. economic recovery, heralded for so many months, was nothing more than a mirage. Even worse, the transatlantic yield differential between U.S and major European interest rates has increased further to the favour of Europe and threatens the U.S. capital account. The record gap between German and U.S. yields (measured in three-month Eurocurrency rates) has widened even more to a punishing 490 basis points (4.9%) and compares with 260 basis points in February before the dollar's rally.

Most people are astonished how weak the dollar is. We, on the contrary, are even more astonished how firm it still is given a record yield gap, a continued heavy dependence on high capital inflows and the wide array of disappointing economic news. More on the sensitive question of the U.S. economy later.

ECONOMISTS: ALL COMPLACENCY AND HUBRIS

As expectations and forecasts are revised downward, the markets adjust to these new perceptions. That explains the dollar's new decline, the bouts of weakness in the U.S. stock markets and also the stampede into U.S. bonds. Yet, we wonder, just what is it that markets are expecting?

The evidence points to many gross contradictions in sentiment and market behaviour but there is one split of opinion that is most conspicuous — the view of Main Street versus that of Washington and Wall Street. Pronouncements from Washington, Wall Street, and from economists generally, are strikingly at odds with surveys that show plunging business and consumer confidence. The latter groups — those on the front lines of the economy — are convinced that the economy is really worse than the economists and the statistics say it is.

Although some economists are beginning to get nervous, most reports still reflect more complacency than anything else. European and German economists, by the way, are hardly any different. We often wonder whether European economists have an independent opinion of their own; they usually echo Wall Street.

For example, a recent report about the world economic outlook, jointly published by the five German economic institutes on October 17,1991, starts with a sentence asserting that a mild recession in North America had ended this summer.

Even more recently, on November 26, 1991, the OECD (Organization for Economic Cooperation and

Development) in Paris, the top international institution in economic affairs, went public with its annual report on the U.S. economy. The report was chock full of bullish expectations. GNP growth for the rest of 1991 and 1992 was projected to run at a 3 to 3.5% annual rate with all components of private sector domestic demand contributing to the rebound. The one and only risk stressed by the authors of these reports was the potential that "*the recovery proves significantly stronger than projected here*", therefore requiring monetary tightening before the end of 1992.

On the very same day of the publication of the mentioned OECD report, Mr. Michael Boskin, President Bush's chief economic advisor, made two remarkable statements in an interview with two Washington Post staffwriters as follows:

> *"We're certainly looking at more moderate growth than even the moderate growth we anticipated. But inflation is dwindling . . . interest rates are falling to the lowest levels in years and the country is working through some problems inherited from the 1980s."*
>
> *"The precursors of growth are falling into line."*

Just one day later, the Conference Board in New York announced a steep plunge in consumer confidence, falling even deeper than the trough reached in the Gulf war and the low point registered in the deep recession of the early 1980s.

PRICE STABILITY: A DECEPTIVE INDICATOR.

It must seem puzzling that the economic experts are the last ones to recognize and comprehend the arrival and severity of the present recessions in the United States and other countries. Actually, we're not surprised at all. Oddly enough, precisely the same thing happened in 1929-30. Then, too, all the leading economists in the United States and Britain completely failed to anticipate the looming depression. The most famous casualty of these false forecasts was the ABC Harvard Barometer which was conducted by various economics professors of unquestionable conservatism. In November 1929, these authors were still firmly predicting that "*a severe depression like that in 1920-21 is outside the range of probability.*" Needless to say, by the early 1930s, the Harvard Barometer was completely discredited and abandoned.

After the war, another popular long-leading index came to be compiled at the University of Columbia's Center for International Business Research. It's Recession Probability Indicator, though, which was designed to sight oncoming recessions based on the average pattern of post-war recessions, completely failed to signal the approach of this last recession. Even now, these indices continue to suggest that economic expansion is continuing. We are told that Mr. Boskin relies heavily on these indexes.

Ironically, the failure of most economists to see the present recession has a close parallel to the 1920s. Today, just as then, falling inflation is widely accepted as the rosy sign of improving economic health.

Traditional economic thinking in the Anglo-Saxon world — prominently in Britain and America — has always been narrowly preoccupied with the notion that the fluctuations of prices are the crucial cause and symptom of the business cycle. The notion is that a rise in inflation is the primary cause of a rise in interest rates which then slows down the economy. Therefore, established monetary theory of the

cycle holds that if only price levels could be kept stable, serious recessions can always be avoided.

In 1929, the U.S. consumer price index was virtually the same level as in 1923. Given this long period of price stability and the great importance attached to it, not only was the Great Depression not anticipated, it was an outright impossibility to most American economists. Even in the midst of the speculative boom in stocks and real estate of the late 1920s, they echoed the view that "*economic conditions were fundamentally sound.*" Their assumption that stable prices were a reliable sign of a stable economy turned out to be fatal.

Today, what is the most popular argument of economists against the probability of a deeper recession? Read again what Mr. Boskin said: "*...falling inflation and falling interest rates... The precursors of growth are falling into line.*" Like so many others, he apparently regards falling inflation and declining interest rates as infallible precursors of recovery and economic growth. Before we come to the flaw in this thinking, let's first take a further sojourn into the history about the question of inflation.

JUST WHAT IS INFLATION?

In the collective works of John Maynard Keynes, there is an interesting exchange of letters, dated September and October 1928, between himself and some staff members of the Federal Reserve of New York. The letters are found under the heading Was there Inflation in the United States?.

This exchange of letters was occasioned by a dispute on the board of a British insurance company of which Keynes was chairman. One member of that board had recommended to sell the bulk of American securities arguing that there was a "serious inflation" in America. Even if the Fed did not act, he said, there must be a violent reaction in the stock market.

Keynes disagreed and wrote a paper on the subject which he sent to six different economists — three British, three American — two of whom were staff at the New York Federal Reserve. In his paper, Keynes defined inflation as being caused by consumer spending in excess of output, resulting in rising prices.

Keynes' British colleagues wholeheartedly agreed with him; but, all three Americans strongly objected. One of them wrote Keynes that Governor Strong "*had found in the paper many points where he believes either your facts or your conclusions are wrong.*" All three Americans explained to Keynes that the United States was experiencing an excessive credit expansion, which, for one reason or another, just hadn't affected commodity prices. They argued that the credit boom had resulted in serious inflation "*in other particular directions*" such as stock prices and real state. Further they said, "*So great has been the supply of credit that speculative builders have been able to mortgage hotels, apartment houses and office buildings for more than the total costs of construction, so that the lender holds the bag and the speculator the equity if there is any.*"

One letter from a member of the Fed staff ends: "*Of course, all this is new to our economists; they do not understand it and they cannot believe it. But I think in another ten or twenty years it will be different.*" What an optimists this pessimist was. Here we are 60 years later and it's clear that these painful lessons have been entirely in vain.

THE PRECONDITIONS FOR A GENUINE ECONOMIC RECOVERY

Back to the present. Essentially, growth forecasts for 1992 have now been downgraded somewhat. Yet, unflinchingly, most professional economists continue to pronounce their good feelings about the U.S. economy's long-term prospects. In general, the only accommodations they've made in their forecasts is to postpone the date of the recovery-start by one or two quarters. That's all. There's little or no inclination to undertake a fundamental re-appraisal of the assumptions underlying these forecasts.

Generally speaking, any recovery from recession depends on three facilitative conditions: liquidity, profitability and credit. Trying to pinpoint an unfolding recovery really boils down to the question of whether these elements are improving. And to do that, we have to distinguish between the consumer and businesses.

CONSUMERS IN TROUBLE

For the consumer to rectify his poor financial condition and to improve liquidity, it's best to cut spending and to sell assets. The problem is that such efforts become self-defeating if everybody is trying to do it at the same time. In such a scenario, the aggregate effect — so goes Fisher's debt-deflation theory — is a general income and asset price deflation. Instead of improving overall liquidity, it is diminished and precipitates recession. Prices of assets fall and become more difficult to sell.

True, American consumer debt-growth has slowed down. Yet, it is easy to see that the American consumer's financial position is not improving at all, but is worsening dramatically. The consumer is being trapped between falling real income and stagnating or falling home prices. On average, his debt-to-income ratio is at an all-time-high and rising while savings and liquidity ratios are at all-time lows. Simultaneously, wealth is declining in most cases due to weakening, partly even plunging, house prices. Yet, all recovery forecasts we've seen, just as always, expect the consumer to lead the advance.

By comparison, the British consumer, with the help of still-rising real incomes, has sharply improved the savings ratio. In this light, the British consumer seems to be in pretty good shape to lead a recovery. What's worse than in Britain than America, though, is the wealth destruction caused by plummeting house prices. Home equity, which used to be the main vehicle for consumer borrowing, has suffered an unprecedented shrinkage. The Canadian consumer's experience is closer to that of his American cousin. To this point, he has been hamstrung by declining home values — precipitous in some regions — declining income growth and no major upturn yet in savings ratios.

Soaring real-estate values and easy credit in all of the Anglo-Saxon countries during the 1980s have played a crucial role in encouraging and enabling home-owners to borrow and spend in excess of income growth. Thus, the wealth effect of soaring house prices became a powerful force driving the past boom. That's no longer the case. Sharp declines in new borrowing are now hitting both home prices and spending, in turn leading to shrinking incomes and setting in motion one of those ill-famed, self-reinforcing, vicious circles.

In sum, the financially-strapped consumer is in no position to launch a recovery in all the above-mentioned countries. If that's the case, can the corporate sector be expected to come to the rescue?

STOCK PRICES AT THEIR BEST, PROFITS AT THEIR WORST

We now come to the most important yet most neglected question in the global economic discussion: the relationship between stock market performance and corporate health and strength. In the Anglo-Saxon countries, paradoxically, hyper-inflation in the stock markets coincides with an unprecedented profit squeeze.

Since mid-1982, when the great world bull market in stocks started, share prices soared in the United States by about 320%, in Canada by about 300%, and in Australia by about 300%. The gains were truly awesome, yet even more mind-boggling is the generally ignored fact that the long economic boom of the 1980s in these countries was a "profitless prosperity" as far as corporations were concerned. For the consumer, the decade was a motherlode of rich capital gains on asset prices; for businesses it was dry hole for profits and return on capital. Profits continued their long secular trend of erosion.

In the United States, pre-tax domestic profits have slumped since the late 1970s from 7 to 8% of GNP to 3 to 4%. While Wall Street endlessly blathers on about an imminent and big rise in profits, third-quarter profits for the S&P Industrials fell 36% from a year ago — the largest year-over-year decline on record. At 3.1%, the after-tax profit margin of the S&P Industrials in 1991 is at a postwar low, well below the 4.0% level registered in the deep trough of the 1981-82 recession.

The profit picture is equally dismal in the other Anglo-Saxon countries. In Britain, the GNP-share of profits has tumbled from 16-17% in the 1970s to 10% recently, and in Canada from 9% to less than 2%. More importantly, these long, sharp downtrends in business profits give every indication of being not just of cyclical origin. Clearly, there are secular underpinnings.

The ferocious profit squeeze is only part of the story. Associated with it is a dramatic shift in the composition of new investment away from manufacturing toward commercial real estate (office buildings, hotels, super markets etc.), trade and financial services. Here, too, the general practice among economists is to only look at the aggregates, which prevents them from recognizing dangerous deformations in the overall economic structure.

In the United States, less than 15% of the net growth in the nation's capital stock since 1983 was accounted for by manufacturing, construction, mining, transportation and public utilities. Net new manufacturing investment virtually stagnated.

In Britain, this structural distortion was even worse. Investment in manufacturing was so low that productive capacity in this sector is no greater now than it was twelve years ago. The same goes for industrial production. Canada, also, witnessed the same shift. Machinery and non-residential assets shrunk from 44% of Canada's non-financial assets in 1982 to 38% near the end of the decade.

Another point, generally not recognized, is that the past, long inflationary credit boom has caused havoc in the financial and economic structures of these countries. The outstanding features common to all of them was debt-fuelled over-consumption and gigantic malinvestments in real estate and consumer-related areas while the industrial base became "leaner and meaner" . . . that is, eroded. Essentially, (See Mises quote on the front page), as a whole, this leaves the nation poorer, not richer.

Money Supply Foreshadows Deeper Recession

By Kurt Richebacher

When early this year all the U.S. money aggregates began to spurt, there was an instantaneous consensus that this was further conclusive evidence of an impending economic recovery. It was clear, money mattered.

Just as suddenly, growth of the broader aggregates stopped dead in its tracks. M2, measuring currency in circulation and demand and savings deposits, is no higher than in February and the broader M4 no higher than in December 1990. For a few months, U.S. economic analysts simply registered disbelief. Later, the unbelievable and impossible provoked a spate of articles asserting that money supply had lost much of its former importance. Suddenly, money didn't matter.

The whopping destruction of asset value and capital continues unhampered. What's left are more and more undercapitalized banks unable to lend.

Favorite Explanation

The favorite explanation is the massive exodus out of low-yielding deposits and short-term assets, counted as money supply, into higher-yielding alternative financial investments outside the money supply, such as bonds, bond funds or initial equity offerings. Statistically, such money movements show up in falling money supply, but accelerating "velocity," or usage of the existing supply. Conclusion: no reason to worry. The money is still there. It just works harder.

This last explanation would have some validity if, in fact, there was evidence that velocity had risen. But there is no such evidence. Something more interesting, and more serious, than a mere shift of portfolio preferences is affecting the U.S. monetary system, and, hence, the capacity of the U.S. economy to grow. It threatens the U.S. with a renewed recession.

What in fact is happening is that the ability of the Federal Reserve to run a pro-growth monetary policy has been seriously damaged by laws designed to bail out depositors in failing savings and loan associations and banks. At particular fault, for reasons I will explain below, is the Resolution Trust Corp., created by Congress in 1989 to take over insolvent thrifts and liquidate their assets.

But first, it is necessary to eliminate the argument that portfolio shifts have increased velocity and are offsetting the lack of growth in the money supply. Or, in other words, that assets and lending are being shifted to non-banks, such as insurance companies and pension funds, from banks.

A look at the available statistics, in particular the Fed's flow of funds account, makes it blatantly obvious that such "compensatory" lending outside the banking system and the money supply is not taking place. To the contrary, non-bank lending has collapsed equally. Contraction has spread from group to group. New credit is plunging all around because all institutions are struggling with the same loan problems, the declining value of loan collateral and erosion of their capital. First the S&Ls, then the banks, now insurance companies, finance companies and commercial paper purchasers.

The figures speak a clear story: Total net new private non-bank lending rose by an annual rate of \$75.9 billion in the second quarter of 1991 and \$51.6 billion in the first quarter. That compares with a peak of \$406 billion in 1988, followed by \$333.8 billion in 1989 and \$275.9 billion in 1990.

In reality, there is a very simple way to cut through all these asset and lending shifts which distort the money picture: Just go straight to the aggregate figures of private-sector borrowing and lending. It immediately disperses the statistical fog. Overall private debt growth, from bank lending to bond issues, has dived precipitously to about 2.7% from almost 14% in 1984-85. That and nothing else is the crucial fact behind the weak U.S. economy and its weak money supply. Taking inflation and interest rates into account, that's a veritable credit contraction. In short, the collapse of money growth reflects a collapse in private credit growth.

Money-supply growth would be much weaker yet had not another source of money creation jumped into action: soaring bank investments. Loan expansion is not the only way the money supply increases. The same deposit-creating effect occurs when banks expand their investments, mainly government bonds, and that is happening on a large scale. Year-on-year bank investments have increased by \$72 billion or 16%. It is all the more ominous that money-supply growth has collapsed despite this massive money creation through monetization of public debt.

Could the problem of the extremely sluggish U.S. money growth solve itself through an acceleration of velocity, as many people hope and believe? Earlier it was possible to say "yes" in theory, providing lending outside the banking system takes up the slack. But given the collapse in non-bank credit growth, the answer is a definite no. The evidence is irrefutable: the ailing money supply is not a dream. It is real. There will be no velocity miracle.

Some people find comfort in attributing the banks' lending restraint to the higher capital requirements applied by the Federal Reserve in 1988 in compliance with an international banking regulation agreement. Instead of being a reason for comfort, however, it is a reason for all the greater anxiety because it implies that the Fed's instruments, reserves and interest rates, are blunted by a fragile financial structure.

Besides, the truth is rather more discomforting. What's really strangling bank lending is not so much the new capital requirements but a colossal shrinkage in the value of loan collateral, particularly through a decline in property values. Small safety margins on their loans force them to absorb a large part of their customers' losses. They are unable to build assets because they have to rebuild capital, and that means a helpless Fed.

All this leaves us with the most important of all questions: Are those influences that are driving this process of credit and money contraction abating or, even possibly reversing themselves? There is a complacent notion that in contrast to the 1930s, S&L and bank failures don't matter because the government takes care of them. That, after all, is what the Resolution Trust Corp., with its massive borrowings, and the bank insurance fund were put in place to do.

Nothing could be further from the truth. The government takes care of the depositors but nobody and nothing else. The adverse effects of the financial crisis are chiefly of four kinds:

(1) shrinkage of deposits;

(2) shrinkage of money supply;

(3) shrinkage of bank reserve demand;

(4) shrinkage of bank asset values and the equity capital-to-asset ratio.

Depositors are the one and only party that loses nothing, because the government bails them out. However, as the government issues bonds for this purpose, the financial services system as a whole suffers a corresponding decrease in the money supply. Purchases of these bonds siphon off existing deposits. That in turn reduces bank demands for reserves. And because the Fed, in its money-supply management, targets the federal funds rate – which rises or falls with bank demand for reserves – it mops up reserves even while money supply growth is stagnant.

The net effect on the financial markets is less money and more government bonds. In short, the RTC operation is akin to a massive contractionary open market operation.

Even more damaging is still another effect on the financial system, namely, the shrinking asset values. While the depositors get new deposits, the S&Ls or banks and their defaulting debtors don't get new assets. The whopping destruction of asset value and capital continues unhampered, impairing the system's ability to create new loans. What's left are more and more undercapitalized banks unable to lend. In sum, the bailout is no bailout for the system, only for the depositors. Indeed, it is compounding the problems.

First Equations

One of the first equations that a student of economics learns is that MV equals the growth of nominal GNP. It's elementary, and MV means money supply (M) times velocity (V). Anybody who asserts that the persistent M weakness doesn't matter ought to explain why he is so sure of rising money velocity. He cannot.

When we look at M2, M3 and M4, we see more than just money supply. Under the surface, we see the virtual collapse in credit-financed private expenditures; we see a ferocious income, profit and cash flow squeeze; we see a vast value and capital destruction centered so far in commercial real estate and hitting the whole range of financial institutions; we see financial structures that are weak and vulnerable as never before. Given these conditions, money supply matters more than ever.

The conclusion is that the extremely weak money aggregates do signal a deepening U.S. recession.

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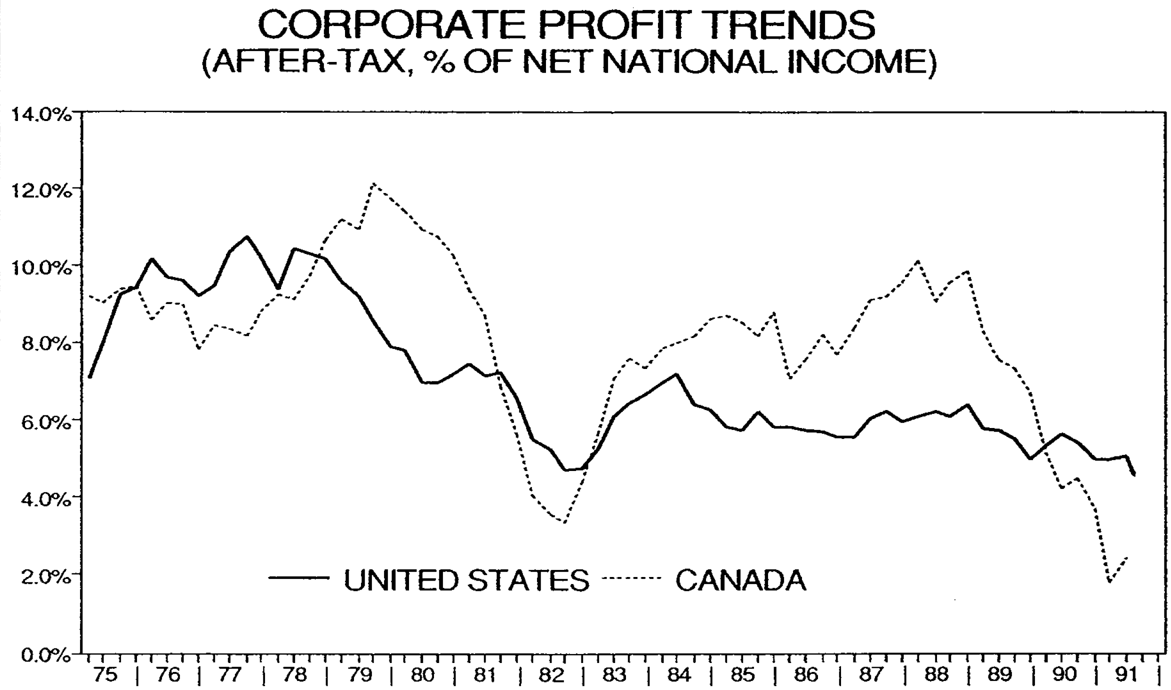


Source: Hahn Capital Partners Inc.

Scanning the business horizon in these countries, we don't see any basis for a business-led recovery. Struggling with vanishing profits and weak balance sheets, businesses are slashing employment and labour costs, and in so doing, are undercutting consumer incomes and consumer demand on which their revenues depend on in the first place. In this scenario, falling inflation and falling interest rates must clearly be seen as failing to stimulate the economy.

CANADIAN BOND MANIA

The belief that falling inflation, in and of itself, is a miraculous sinecure, probably finds its greatest expression in Canada. Global investors appear to have gone crazy on Canadian bonds, and no doubt, in the rush they have fared splendidly so far. What draws them is a "healthy" decline in inflation, fairly attractive interest rates and a single-minded central bank. Flattering talk of a new "Bundesbank North" which wages an unremitting fight against inflation and a "new member of the hard-currency elite" have become common phrases in the heat of the feeding frenzy.

Here we quote a bullish Canadian broker expressing the typical view . . . an opinion, incidentally, parroted by most international brokers as well.: *"Canada is now making rapid progress against inflation. Canada has better economic growth potential than most of its major trading partners . . . Corporate profits, which fell to a dramatic low, have begun to rebound and we will quickly see the emergence of the 'best of all worlds' for investors, fast-rising profitability coupled with falling short-term and long-term interest rates."*

Unfortunately, we see a lot more than the broker does. For example, Canada's unit labour costs have

jumped 20% between 1987 and 1990, the highest rate among the G-7 countries. Productivity increases have slowed from an average of 2% a year in the 1960s to 0.7% in the 1970s and 0.2% in the 1980s. Again, that was the worst performance of the G-7 nations.

How can there be sharply falling inflation given such atrocious cost and productivity conditions, not to mention large doses of government-induced inflation? It's very simple: hard-nosed monetary and exchange rate policies have squeeze business profits virtually out of existence.

Surveying Canada's economic landscape, it's not hard to discover where the major deflation has been — corporate income statements. Profits have collapsed by more than 6 percentage points of GNP in the past 2-3 years to the lowest levels since the 1930s, representing little more than 2% of net national income. The one and only thing that's still booming in Canada is foreign indebtedness which, lately, is mainly financing public spending. Foreign indebtedness is up from approximately $68 billion at the beginning of the 1980s to well over $260 billion, or near 40% of GNP.

The unbridled euphoria in Canada's securities markets is truly bizarre given the facts. At the end of 1990, non-residents owned $179 billion of Canada's outstanding bond market, or 38% of the total, up from only 12% in 1980. In contrast, Canada only owns $6.8 billion of foreign bonds. Japan alone holds as much as 25% of all foreign-held Canadian bonds, up from less than 10% a decade ago. Given the enormity of this high-yield bond bubble, it's no wonder that the Canadian dollar has soared from less than U.S.$0.70 in early 1986 to over U.S.$0.89 in recent months.

What most others call a healthy development we regard as a paranoid situation. The Canadian economy shrinks even in the midst of the excess liquidity supplied from abroad. If it weren't for the rise in foreign indebtedness during 1990-91, GNP growth would have been more than 2% lower per annum. But this liquidity — broad money is growing at a rate of 6.2 % — is piling up in the financial sphere while the outlet to the real economy remains clogged.

DOWNTURNS HAVE COMPLEX CAUSES

What's wrong with Canada's real economy? Exactly the same things that are wrong with the American, British as well as a few other economies: on the micro-level, grossly maladjusted demand, output and capital structures. Keynes once said: "*Cheapness which means the ruin of the producer is one of the greatest economic disasters which can possibly occur.*" Profit deflation translates into income deflation, and vice versa.

The point is that the underlying causes of the recessions in the Anglo-Saxon countries are more complex than the simple inventory cycle syndrome. These causes are much deeper-seated than money, credit and debt. In the last analysis, it is a combination of a debt crisis and a long-term growth crisis, both of which were caused by a prolonged credit inflation that fuelled consumption, financial speculation and massive malinvestments (in real estate) at the expense of savings and productive investment. Non-productive assets grossly outgrew income-producing assets.

The predictable, inevitable result was a progressive erosion of the industrial base impairing future productivity growth. Increasingly, productivity gains in these countries have been due to the closing of inefficient capacity and labour-shedding rather than new investment. So to speak, the industrial base

has been shrunk down to a more efficient core.

WHAT NEXT?

Both the world economy and financial markets are in a critical transition period. The boom of the 1980s is definitely over and the bloom on the financial rose is over-aged. Just what can be expected to follow?

As widely predicted, economic activity in Europe, too, is rapidly decelerating as the strongly expansionary effects of German unification are unwinding. Britain and the Scandinavian block are in deep trouble. The Japanese economy, also, is losing steam.

Given these new downtrends, the most important question really is whether there'll be offsetting strength from any recoveries in the Anglo-Saxon countries — after all, these were the first economies to enter recession. If these countries fail to take off, it would imply a deepening world recession, and depending on the final outcome, the impact on the markets — stocks, bonds, currencies, gold — could be dramatic.

True, consumers and businesses have written off any near-term hope for a recovery. But, market opinion counselled by most economists, considers the recovery to be merely delayed, not derailed. It's just a minor timing error. Unaware of the true nature of this "recession", the stock market still salivates at the prospect of a "classical" cyclical recovery that will herald, as always, booming profits, rising interest rates and a surging dollar.

We draw two different conclusions: firstly, recent economic and monetary data show nothing that could even remotely support any expectations for recovery; and secondly, underlying conditions are mostly still worsening, not improving.

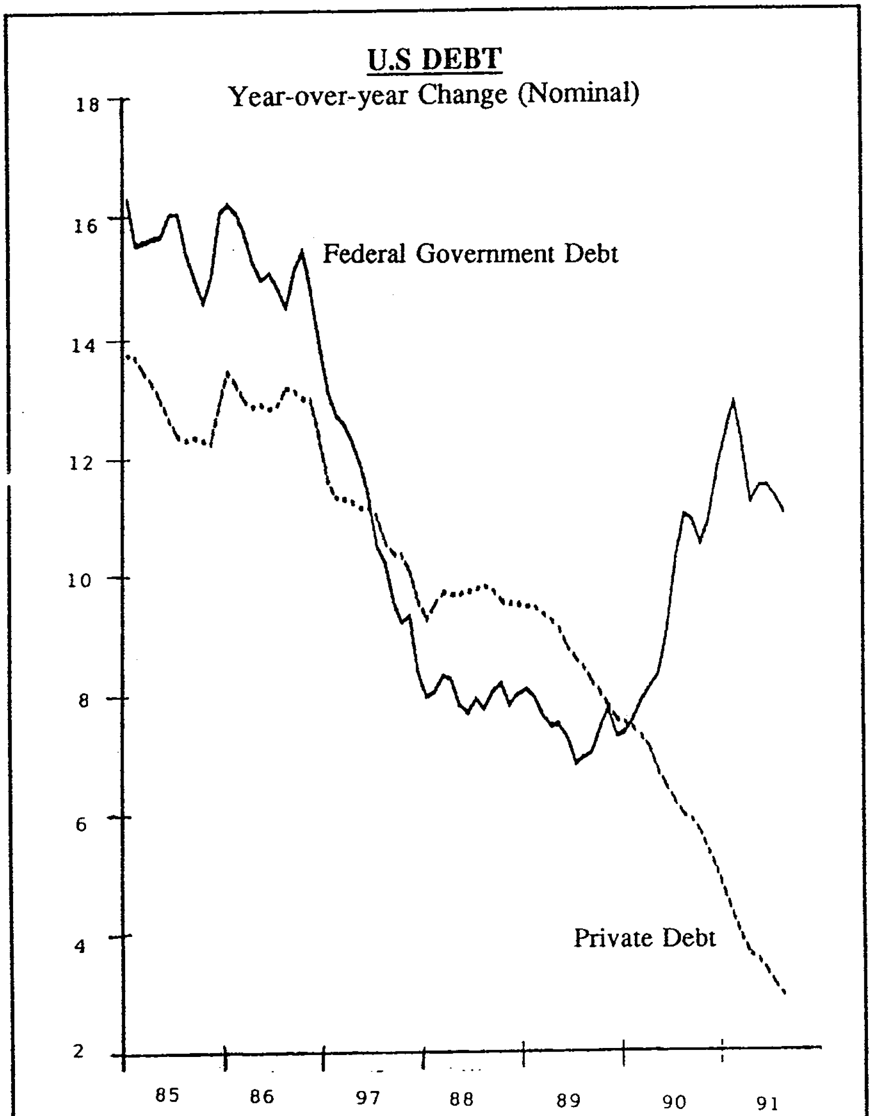
CREDIT: THE CRUCIAL INDICATOR

The profit and income squeeze, as described, certainly shows all signs of still being in force. Any recovery, consequently, would either have to come from outside — a new export boom — or from a renewed domestic credit expansion. Given the present internal and external conditions — the global economy is slowing — it's clear that aggregate spending can only be raised by a renewed credit expansion. What must happen is increased business or consumer borrowing that finances higher investment and/or consumption expenditures. That, in fact, is what the drastic monetary easing in all of the recession countries is desperately trying to achieve.

In short, under these conditions, private-sector credit growth is the crucial indicator and precursor to an economic recovery. The decisive reality, though, in the United States, Britain, Australia, Canada and other countries, is exactly the opposite — an unprecedented credit crunch.

Despite steep interest rate reductions in all of the recession countries, so far, private credit growth remains "dead in the water." In the United States, private-sector credit growth has fallen from 11.6% in 1987 — even higher before that — to only 2.5% recently, in Britain from 23% to barely 3%, in Canada from a high of 13.1% to 3.3%, and in Australia from 25% to 0.6%. All of this suggests a deeper descent into recession, not an imminent recovery.

Not only that, more recent weekly money data in the U.S. shows that the situation is going from bad to worse. In the 13-week period ending November 18th, U.S. M2 growth slowed to 0.2% at an annual rate, while M3 has actually contracted by 1% over the same period. Both growth rates are at new lows.



Source: Datastream

Given the horrible monetary data, the commentary we have read from American economists has been chillingly amazing. Jointly, they discard the extraordinary monetary sluggishness as being purely technical and of no significance for the economy. A common plank of these views is that money is rushing out of low-yielding money assets (money market paper and deposits) into higher-yielding bonds or bond funds which are not counted as money supply. What's being completely ignored is that the commercial banks are pumping out new money at an accelerating pace by buying government bonds, $16 billion alone in October and $86 billion since the end of 1990. The trouble is that collapsing private-sector credit is largely offsetting this massive money creation. (Please see the adjacent graph).

We've explained the complicated technicalities of these contractionary dynamics in several recent letters. Rather than repeat it again, we've enclosed our explanation of the current monetary picture and its negative implications which was carried in the Wall Street Journal on November 13, 1991.

THE BATTLE OF THE CURRENCIES

1992 was supposed to be the year of recovery for the world economy, led by an U.S. locomotive. It's time to consider the probability and implications of the exact opposite — a spreading and deepening world recession. In our opinion, the recessions in the most imbalanced countries — United States,